90-06723/

C.D. Howe Institute

Commentary

No. 20, August 1990 ISSN 0824-8001

Canada at the U.S.-Mexico Free Trade Dance:

Wallflower or Partner?

by

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Mexican and U.S. interest in negotiating a free trade agreement presents Canada with a critical choice: to participate or to stand aside. By participating, Canada may gain greater opportunities to trade with a newly outward-looking 85 million-strong market. By standing aloof, Canada risks losing growing Mexican trade to U.S.-based companies and losing investment to the United States because only U.S.-based firms would have tariff-free access to all three markets.

If Canada joins in, free trade in the Western hemisphere may evolve on the principle of *plurilateral regionalism*, by which all participating countries would have equal access to all markets and all would bargain together. By contrast, a bilateral U.S.-Mexican agreement could set hemispheric free trade on the path of the *hub and spoke* model, in which the U.S. hub would have a separate agreement with each spoke country. This would give the United States the advantages of bargaining separately with each partner, and of being the *only* country with tariff-free access to the markets of all participants.

One way to expand the existing Canada-U.S. Free Trade Agreement (FTA) to include Mexico would be to draw the key principles governing trade in goods and services from the present FTA to form a *core agreement* that Mexico (and other countries) would sign. Each new entrant would also negotiate a *penumbra agreement* covering exceptions of all sorts, which should be sunsetted wherever possible. And as for the fear that cheap Mexican labor will outcompete Canadian labor, in what matters most, costs per unit of output, Mexico does not outcompete Canada overall.

Introduction

There is a good chance that, early in the 21st century, virtually all goods and services will move duty free across the U.S.-Mexico border!

Mexican and U.S. officials have already made preliminary contacts, feasibility studies are under way, and the Mexicans have appointed the senior members of their negotiating team. U.S. President George Bush and Mexican President Carlos Salinas de Gortari met in Washington in June and accepted the principle of joint trade-liberalizing negotiations. Bush has recently stated that he will ask the U.S. Congress, as early as mid-September, for authority to negotiate a trade-liberalizing agreement with Mexico using the fast-track procedure.[2] In his message to Congress, Bush must identify the countries with whom the administration wishes to negotiate. Sixty working days must then elapse. During that time, Congress can debate the request, and at the end of the period, it must grant or refuse the authority. If approval is given, a year or two of hard negotiations will follow and, by 1993, the first round of tariff reductions could be taking place under a U.S.-Mexico free trade agreement (FTA) similar to the one that now exists between Canada and the United States.

And where will Canada be when all this is happening?

Canada's Options

There is a chance that Canadians will be a part of the bargaining process and that Canada will end up inside a greater North American free trade area encompassing Canada, the United States, and Mexico. There is also a chance, however, that Canadians will find themselves on the outside looking in at a bilateral, U.S.-Mexico FTA. This would put the United States in a highly privileged position as the *only* country with free access to all three large, and growing, North American markets.

So when Canadians assess their future trading options, the most likely status quo for the 1990s is not the current situation, but one with a U.S.-Mexico FTA firmly in place. There is no point in arguing whether such a further extension of regionalism is desirable. It will occur (or not occur) for reasons quite beyond Canada's control. The only issue facing Canadians is: Will we elect to be on the inside, or outside, of such an arrangement?

If Canada is to be constructively involved in the negotiations, it is important that Canada be involved from the beginning. Otherwise the United States and Mexico will determine both an agenda, to which Canadians will merely react, and a set of ground rules for negotiations, which Canadians will have to follow. So, for full and effective participation, a Canadian decision is needed before President Bush approaches Congress. If that window of opportunity is missed, we may have to stand aside until a U.S.-Mexico bilateral agreement is reached and then react to that *fait accompli*.

I believe that Canada has much to gain from deciding to take part in any negotiations and much to lose from standing aloof. The reasons fall into two main classes, which are discussed below: first, those associated with the gains from trilateral free trade and, second, those associated with the dynamics of future hemispheric trade liberalization.

Trilateral Free Trade

The Mexican Background

Mexico has a population of close to 85 million people, but a per capita GNP of only about one-tenth that of either Canada or the United States. It is currently a seriously underdeveloped country experiencing rapid population growth and enormous disparities between rich and poor. The public-sector payroll is excessive for so poor a country; and infrastructure — in terms of transportation, communication, and education — is still poor by the standards of advanced countries.

In recent years, however, the Mexican government has been dismantling its inward-looking policies and increasingly exposing its economy to market forces — along the lines now being followed by the countries of Eastern Europe. For example, state subsidization of industry has been greatly reduced, many quota restrictions on imports have been removed, and high Mexican tariffs have been unilaterally reduced to levels similar to existing Canadian tariffs. This means that in the last five years Mexico has reduced its barriers to international trade, thus opening its economy to international competition, by about as much as Canada has done in the past 50 years! If the Mexican government continues with its reforms at the current rate, its economy could soon be as open to market forces as those of most advanced industrial countries.

The liberalization of the internal market, together with the proposed further liberalization of the external market through free trade with the United States (with or without Canada), could return Mexico to a rapid growth path — the path from which it was knocked by the collapse of oil prices and its ensuing external debt problem. If so, the country will enjoy steadily growing living standards.[3]

Reaching either a bilateral or a trilateral agreement with Mexico on across-the-board trade liberalization will not be an easy matter. The gap between the living standards of countries, the need for really large-scale Mexican adjustments, the still-controlled and subsidized nature of some sectors of the Mexican economy — including petrochemicals — pose formidable problems. There is reason to hope, however, that given goodwill and determination on all sides, a mutually acceptable agreement can be reached.

Canadian Opportunities

Canada, the United States, and Mexico constitute a vast market in excess of 320 million people, larger in number than the European Community (EC). We have noted, however, that the 85 million Mexicans currently have a per capita GNP of one-tenth that of Canadians and Americans. This makes them the equivalent in purchasing power of about 8.5 million U.S. or Canadian consumers. If the liberalization of the internal economy, and of foreign trade, were to return Mexico to, say, a 5 percent growth path, Mexican real incomes would double in about 14 years. This would be the equivalent of adding 8.5 million U.S. or Canadian consumers to the North American trading area over that time period. Should Mexican real incomes reach half those of Canada or the U.S., it would be the equivalent of an additional 34 million Canadian or American consumers. The growing Mexican purchasing power will buy local and imported goods in large quantities. The additional demand for imports so generated will provide significant new opportunities for U.S. and Canadian firms to sell in Mexico. This favorable "income effect" — a rise in Mexican imports from Canada due to rising Mexican incomes — is in addition to the usual "resource reallocation effect" — the gains from redirecting the nation's activities in the direction of its largest trading advantage — that follows from a liberalization of trade.

Gaining free access to a new market whose current purchasing power is equivalent to 8.5 million Canadian consumers, and which can be expected to rise to the equivalent of many more millions, is one of the major positive advantages to Canadian membership in any FTA that included Mexico.

On the negative side, if Canada stays out, substantial trade and investment diversion must be expected. If Canadian- and Mexican-produced goods do not have tariff-free access to all three markets, while U.S. goods do, the United States will have a clear advantage in selling to either market in competition with products from the other country. In particular, Canadian exporters to Mexico will have to pay the Mexican tariffs while their U.S. competitors will not. Similarly, firms wanting to serve the whole North American market will be attracted to the United States as the only location to give them tariff-free access to all three parts of that market. This will be a particularly

strong pull for multinationals deciding on locations from which to serve the whole market, both as it is constituted after a trilateral agreement and as it might subsequently evolve through further extensions of the hub and spoke model.

This trade and investment diversion can only hurt Canada. It will occur whether we like it or not, *if* the U.S.-Mexico negotiations succeed and *if* we elect to stand on the sidelines.

Hemispheric Free Trade

Long-Term Prospects

The discrediting of inward-looking, non-market-oriented economic policies in the formerly socialist countries of Eastern Europe, and in an increasing number of the less developed countries throughout the world, is influencing many countries to adopt outward-looking, market-oriented economic policies. As a result of this new orientation, regional trade liberalization will come to have a renewed appeal to many countries throughout the world, including those of the American hemisphere. This appeal will be reinforced once successful examples of Canadian, U.S., and Mexican free trade can be observed by others.

As a result, any U.S.-Mexico free trade association is best viewed as the second stage in a continuing process of the evolution of trade liberalization throughout the American hemisphere. The final result — possibly many decades away — could be something close to free trade among all of the countries of the western hemisphere — *hemispheric free trade*. This is a development for which even President Bush has recently called.

There are many formidable problems stemming from deep social and political divisions in many Latin American countries, divisions that often cause political and economic upheaval. Nonetheless, the pressures to achieve growth through international trade are likely to increase over time. Those who view free trade among the countries of North, Central, and South America and the Caribbean a pipe dream should remember that eight short years ago Canada-U.S. free trade also seemed a pipe dream, as did U.S.-Mexico free trade a mere two years ago.

Moving toward hemispheric free trade means moving toward an integrated market that currently includes about 708 million people. Many of the countries that comprise this market have great potential for growth — at least after their governments get their economic policies onto a market-oriented track (and some pressing social issues are dealt with). Adherence to a large regional FTA would come close to forcing the needed movement to more market-oriented policies.

Surely Canada does not want to stand outside, merely watching the growth of such a giant market, and remaining a free trade partner of only the United States.

Two Models for Regional Trade Liberalization

With or without Canada, there are two models for the evolution of hemispheric free trade, the *hub and spoke model* and what may be called *plurilateral regionalism*. The choice between the two will have major consequences for the countries of the western hemisphere. Canada's actions — by taking part in, or standing aloof from, the U.S.-Mexico negotiations — will influence, possibly even determine, which choice is made.

Hub and Spoke: In the hub and spoke model, the United States has a separate bilateral free trade agreement with each of the other participating countries. If the United States and Mexico negotiate a bilateral agreement, hemispheric trade liberalization will be evolving toward the model of the United States as the hub and the other American countries as the spokes. Once begun, this process may be hard to change.

There are several reasons why the adoption of the hub and spoke model should be resisted by countries other than the United States.

- As the hub country, the United States becomes the only country with tariff-free access to the markets of all participating countries. As spoke countries, the other participants — including Canada — have tariff-free access only to the U.S. market. Thus this model creates trade diversion in each of the markets of the spoke countries; the beneficiary is the United States, the losers are the other spoke countries.
- The United States will also benefit from investment diversion at the expense of the spoke countries. Locating a plant in any spoke country provides tariff-free access only to the United States and the local spoke market. Locating a plant in the United States, however, provides tariff-free access to the United States and to the markets of all of the spoke countries.
- The United States is placed in a superior bargaining position. It creates separate agreements with each of its smaller partners so that they have no chance to make common cause against the United States in areas of mutual interest. This gives the United States a dominance that it may not particularly desire, but which the logic of the hub and spoke model thrusts onto it.

Plurilateral Regionalism: What can be called *plurilateral regionalism* is an important model. The term refers to regional free trade areas (or customs unions, or common markets) in which *all* members have the same privileges and obligations as do all other members. In particular, each country has tariff-free access to all other members' markets. This makes the regional grouping plurilateral in the sense that all participants are treated equally. In contrast, the hub and spoke model gives the hub country a position that is superior to those of all of the spoke countries.[4]

In the present case, plurilateral regionalism calls for a trilateral agreement covering Canada, the United States, and Mexico. It is not a matter of the three countries sitting down at one bargaining table to work out separate bilateral agreements with each other. Instead a single trilateral agreement would be negotiated. Such an agreement would be capable of being expanded to take in other countries in the Americas until it became, in the limit, a single hemispheric free trade area in which all countries of the hemisphere have tariff-free access to each other's markets.

Whereas the hub and spoke model is a model of U.S. hegemony over the Americas with each country tied only to the United States, plurilateral regionalism is a model of equals. All members have access to each other's market; all bargain together, and all are free to make common cause with others of like mind in common trade negotiations.

Canada to Decide

Canadian nationalists often complain that their country has little power to influence U.S. behavior. Rarely has Canada had such an opportunity as it now has to determine the choice between two courses of action. Senior members of the American administration have made it clear that they would welcome a Canadian request to become involved in the negotiations. For obvious reasons, the United States must wait to be invited by Mexico and/or Canada rather than appear to be pressuring its smaller neighbors. Although everyone in the United States might not welcome Canadian participation,[5] it would be almost impossible for the United States to deny Canada a place, given the public stand of the administration providing only that the Canadian government shows a clear and unequivocal desire to take part. Many Mexicans may prefer the simpler course of bilateral negotiations, and it remains for Canada to persuade them of the mutual advantages to be gained from trilateral negotiations. This may not be an easy task and Canadian officials should be urgently researching their brief on this matter.

If Canada elects to stay out of the U.S.-Mexico negotiations, hemispheric trade liberalization will be well on the way to the hub and spoke model with the United States already as hub to two North American spokes, Canada

and Mexico (plus a third transoceanic spoke to Israel). If Canada opts into the negotiations (and its presence is accepted by the other two countries), a decisive push will have been given toward plurilateral regionalism. The tripartite Canada-Mexico-U.S. FTA would become the agreement to which further countries could accede creating a growing hemispheric FTA.

The Structure of a Tripartite Regional Agreement

Structuring an agreement to liberalize trade among the three countries poses many difficulties, particularly in the light of the existing Canada-U.S. agreement. It is not clear whether officials in *any* of the three countries have had time fully to think through all of the important institutional problems. A great deal of work among experts is needed before all of the possible arrangements can be outlined and their pros and cons fully evaluated. In the meantime, I discuss four major possibilities for purposes of illustration.

- One possibility is to have Mexico sign the Canada-U.S. agreement. To make this a viable option, some chapters in the Canada-U.S. agreement would have to be renegotiated, while others might have to be added to cover special Mexican concerns.
- A second possibility is to have Mexico and the United States negotiate their own bilateral agreement and then somehow to bring Canada into that agreement through a second round of negotiations.
- A third possibility is for Canada and Mexico to negotiate their own separate bilateral agreement after the U.S.-Mexico agreement is in place. This would institute free trade among the three countries through three separate bilateral agreements.
- A fourth possibility is to draw a core agreement from the existing Canada-U.S. agreement. This would certainly cover free trade in goods, and probably also the liberalization of services and investment. Mexico, and any other country, could join the free trade area by acceding to that core agreement. Each new signatory would also bargain a separate penumbra of special deals with each or all of the existing contracting parties relating to issues of special concern.

Much thought is needed before the technical feasibility of each of these alternatives is decided and their pros and cons fully delineated. In the meantime, here are some issues that each would raise.[6]

Case 1: Bring Mexico into the Current Agreement

The first possibility would work best if Mexico could sign the whole existing Canada-U.S. agreement, which would just have its wording changed to cover the three countries. This seems unlikely because both the United States and Canada might be unwilling to extend to Mexico all of the concessions that they made to each other when bargaining their agreement. For example, would the United States be willing to grant to Mexico the same exemption of cultural industries that it granted to Canada? Would Mexico want such an exemption? What about beer and wine, and review of takeovers of firms in excess of $150 million in size?

Probably, the United States and Canada will be reluctant to let Mexico into every detail of the existing deal. For analogous reasons, Mexico will be reluctant to accede to that deal as it is without bargaining over its own special interests. This mutual reluctance will be strengthened by the realization that what happens with Canada, Mexico, and the United States will set the precedent for further extensions of the FTA to cover other countries of the western hemisphere.

The only acceptable way to handle this approach, therefore, would be to reopen the agreement and renegotiate those chapters that either the United States or Canada were unwilling to extend to Mexico and those chapters that Mexico was unwilling to accept as they stand. Among other things, this procedure has

the grave disadvantage of reopening some of the delicately crafted compromises that are found in the Canada-U.S. agreement. Would Canada be able to resist U.S. pressure to make more concessions where it held out for exemptions in the previous negotiations? Would the United States be able to resist Canadian pressure for similar alterations? I suspect most negotiators and members of both the Canadian and the U.S. administrations would be reluctant this early in the life of the agreement to put its details up for renegotiation. (Nor do I think it a good idea myself.)

Nonetheless, this alternative does appeal to those Americans who are dissatisfied with some compromises reached in the Canada-U.S. negotiations. It also may appeal to some Canadians who are severe critics of some of the details of the present agreement. For example, opponents of the energy chapter may like to reopen the agreement in the hope that they could make common cause with the Mexicans to soften some of the aspects of that chapter, particularly the sections on sharing in times of crisis. Such a reopening would, however, be a double-edged sword. Although Canada might get some alterations to the energy agreement by making common cause with the Mexicans,[7] it could not be sure of being able to resist combined U.S.-Mexico pressure to remove the exemption it negotiated for the Canadian cultural sector.

Case 2: Bring Canada in as Phase 2 of the U.S.-Mexican Agreement

This second possibility has the disadvantage that the second stage of bringing Canada in could founder, either at the negotiating or the ratification stage, leaving the hub and spoke model in place by default. It would be risky for Canada to stand by until a U.S.-Mexico deal was in place, trusting that Canada could be brought in later. Further, Canada might then be faced with a take-it-or-leave-it choice in signing a deal that Canada had played no part in negotiating and whose special provisions would reflect Canada's particular concerns only by accident. If it tried to renegotiate some of the U.S.-Mexico compromises, its evident desire not to be left out of the whole deal would put it at a bargaining disadvantage, as would the understandable U.S. and Mexican reluctance to reopen their carefully crafted mutual compromises.

Case 3: A Separate Canada-Mexico Bilateral Agreement

The third possibility might just be feasible with respect to trilateral free trade. Three separate bilateral deals, each instituting free trade but each reflecting the special bilateral concerns of the pair of countries who were signatories, would be technically feasible. At least three serious objections may, however, be raised. First, it greatly enhances U.S. bargaining power since the United States meets each of its spoke partners separately while they have no chance to make common cause where their interests diverge from U.S. interests. Second, since trade between Mexico and Canada is currently so small, it can be doubted if the political will would exist on both sides to persevere with the long, difficult process of reaching a bilateral agreement. Finally, this procedure could not easily be extended to cover evolving hemispheric free trade. Agreement among even five countries would become unmanageably complex with 10 separate bilateral deals being required.

Case 4: A Plurilateral Core with Bilateral Penumbra

The fourth possibility provides for the core of what constitutes free trade to be placed in a single agreement to which any number of countries could be signatory.[8] This would require detailed work in extracting the core model from the current agreement. At this stage, decisions would have to be made about the content of the core model. It clearly covers free trade in goods, but what else does it include?

The Core: Preliminary candidates for the core are chapters 1–6, 11, 14–15, 18 and parts of 20 of the existing Canada-U.S. agreement. Even this selection poses some difficult problems of both inclusion and exclusion.

Chapters 1–6 cover the introduction on objectives, the definitions, the rules of origin, border measures, national treatment and technical standards. These are the guts of the agreement for free trade in goods. Rules of origin may prove difficult but will have to be settled whatever institutional route is taken. Similar comments apply to the other parts of these six core chapters.

Chapter 11 on emergency action is an important limitation to trade-restricting measures. Although Mexico may want some additional scope in this respect, the measures should be clearly sunsetted and placed in the penumbra agreement with the guts of Chapter 11 being the situation to be reached after any special transition measures had run their course.

Chapter 14 provides the limited, but nonetheless important, extension of the agreement to cover services. In the long run, as the distinction between goods and services production becomes more and more blurred, "free trade in goods" should routinely come to mean "free trade in goods and services." There may be some resistance from Mexico to including this chapter in the core. But this should be included with the addition of sunsetted provisions added to the penumbra chapters to cover a transition period for Mexico — one that could be quite long.

There is a useful principle here: *never say "never," just say "a very long time."* The Canadian and American negotiators would have been well advised to apply this in the bilateral case: exclude something for 50 years if you must, but never exclude it forever. Time discounts are such that even strong special interest groups will often settle for protection in their own lifetimes. Time, however, ticks on inexorably, and an agreement with no "nevers" but only some "very long exclusion times" would slowly evolve to a complete, unequivocal free trade area. (Think, for example, of the great boon to the world if, in the negotiations leading up to the 1957 Treaty of Rome which established the EC, instead of giving in to French pressure and adopting the common agricultural policy [the CAP] indefinitely, Germany had insisted on sunsetting the measures after 40 years. That would have seemed forever in 1958, but as 1998 comes nearer, the difference between never including agriculture in free trade and including it after 40 years would seem more and more important.)

Chapter 15, the imaginative provisions for temporary entry for business persons, should be extended without change to Mexico. However, those who worry about illegal Mexican immigration to the United States might make a red herring of this chapter, arguing that it was a further chink in the border.

Financial services will pose serious problems, since the Canadian market is largely deregulated, while the U.S. market is significantly regulated and the Mexican market is heavily regulated. It would seem a good idea to have some principles about right of establishment and national treatment of financial services in the core and then have the current body of special treatments, which would include most of the existing Chapter 17, in the penumbra.

Common dispute settlement procedures are clearly needed with respect to disagreements arising out of the agreement itself and changes in national laws that may impinge on the agreement. These are currently found in Chapter 18 and it would be desirable to include in the core the whole of this chapter as it now stands.

Chapter 19 on the binational dispute settlement of antidumping and countervailing measures will pose problems. This is supposed to be a temporary measure while the bilateral negotiations on a subsidy code take place. If these negotiations do not reach complete agreement,[9] the Chapter 19 dispute settlement mechanism may well become permanent. Chapter 19 was made possible in its present form because the United States and

Canada have similar countervail and anti-dumping laws and similar administrative procedures for applying these laws. Mexico does not meet either of these conditions, nor does it have the concept of administrative law and judicial review that is found in both the United States and Canada.

How should the countries proceed given these grave complexities? On the one hand, a common method of dealing with disputes over the application of fair trade laws would seem to be desirable. Two significantly different mechanisms for settling such disputes would cause invidious comparisons and continued friction with the partner who thought it was covered by the inferior mechanism. On the other hand, giving up what we now have in Chapter 19 would be undesirable. After all, the chapter includes some special concessions made by the United States on such things as review of proposed legislation which it may be reluctant to extend to other countries. It would be a shame to lose the bilateral application of some of these imaginative provisions. How to do both will require a considerable exercise of ingenuity and bargaining talent.

The Penumbra: Exclusions also pose problems. Suggested exclusions are chapters 7 on agriculture, 9 on energy, 13 on government procurement, 16 on investment, 17 on financial services, 19 on dispute settlement of fair trade laws, and parts of 20, in particular, section 2005 on cultural industries. All of these have some carefully crafted compromises relating to points of bilateral friction. Mexico's special interests will hardly lead it to want to accede to these provisions without revision. In some cases, it may want more restrictions (e.g., possibly in energy and autos) and in other cases, it will want fewer restrictions (e.g., probably in cultural industries where Mexico may feel it will gain more than lose from free competition, particularly in the border area). Chapter 20 is a rag bag of miscellaneous provisions, some of which clearly belong in the core while others clearly belong in the penumbra.

It would also be necessary to decide how the noncore chapters would be negotiated, and whether or not they would be embodied in a single trilateral agreement or separate bilateral ones. These problems could get unmanageably complex as the number of countries, and the number of issues that were accepted to be special, increased. One solution, which would not recommend itself to everyone but which may in the end be the only practical one, would be to reduce drastically the number of exemptions and special cases in the Canada-U.S. agreement. This would reduce the size of the whole agreement by reducing the noncore chapters and bringing them in under the general headings of free trade in goods or in services. (What then of beer, culture, transportation, etc.?)

The Dividing Line: The above discussion suggests one principle that might help to delineate the core from the penumbra, and also help to strengthen the core. The core would be based on the principles of fully free trade in goods and services. This would be the end to which the actual free trade area would evolve when all sunsetted provisions had expired. The penumbra would contain a set of exceptions, phase-in allowances, adjustment provisions and special cases. In all possible cases these would be sunsetted (over 50 or 75 years if necessary) rather than being permanent. The number of permanent special provisions would be kept to a bare minimum. Over time the penumbra would wither away leaving trade among the partners to be governed mainly by the core.

This procedure would mean that there would be only one core agreement, one that would be signed by each new entrant at the time of entry. There would also be only one penumbra agreement for each country. This agreement would have been bargained between each new entrant and all of the existing members of the FTA. At any one time, however, there would be a series of old penumbra agreements, each applying to one member, negotiated at the time of that member's entry, and

each slowly eroding as its particular sunsetting provisions came into play.

A Tentative Conclusion

The above discussion exhausts neither the possibilities for institutional arrangements, nor the pros and cons of those possibilities that have been listed. There are subtle differences between the approaches, differences that may not be apparent at first sight. In particular, although cases 1 and 4 could evolve to something similar, the negotiations would start from different points, with different things taken as given, and this could significantly influence their outcomes. Clearly, much more thought is needed on these crucial mechanics before negotiations are even discussed, let alone opened. In the meantime, the preliminary conclusion is that some variant of Case 4 is likely to be the best route to follow.

The Critics

The suggestion of an FTA with Mexico is likely to arouse major controversy in Canada. Although there is not space here to consider all the points that will be debated, a few comments may be useful.

Fear of Trade with Low-Wage Mexico

One major fear will be that Canadians cannot risk trading freely with Mexico because of that country's cheap supplies of labor, which will give Mexican goods an overwhelming competitive advantage.

Mexican wages are typically only 10 percent of Canadian wages. Mexican unskilled labor gets something like $0.60 an hour, calculated at the existing exchange rate, while typical Canadian tariffs against Mexican goods are 10 percent or less. A 10-percent tariff turns Mexican costs of $0.60 an hour for producing for the local market into costs of $0.66 an hour for producing for the export market! If we really had to worry about the competitive advantage conferred by low Mexican wages, then *existing Canadian tariffs* would provide little relief: if "sixty-cent-an-hour wages" are a threat, then "sixty-six-cent-an-hour wages" are not much less of a threat.

Clearly, there has to be something wrong with the low-wage argument, and the great 19th-century economist David Ricardo long ago showed what it was. He refuted the belief that rich, high-wage countries cannot trade profitably with poor, low-wage countries by showing that the exchange rate is the mechanism that equilibrates trade, creating a balance between imports and exports.[10] What matters in international competition is not how much local labor is paid in terms of purchasing power. What matters is how *unit costs of production* compare internationally *at the going exchange rates*.

By and large, Mexican wages are low in terms of purchasing power because the productivity of Mexican workers is low. Unit labor costs at the existing dollar-peso exchange rate

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Quotation with appropriate credit is permissible.

ISBN 0-88806-264-8

are more or less comparable to those in Canada, higher in some industries and lower in others. This, of course, is just what Ricardo's theory, and the experience of the many rich countries that have successfully traded with poor countries, would lead us to expect.

Trade liberalization will require adjustment (without which there would be no gains). Mexico can produce some things cheaper than Canada does and Canada can produce other things cheaper than Mexico does. This is the source of increased trade flows between the countries and of the rising incomes that result from concentration on the things that each can produce best. On balance, one would expect Canadian job creation to be more concentrated in the high-value-added, higher-wage industries and Mexican job creation to be more concentrated in the lower-value-added, lower-wage industries. (There will, of course, be notable exceptions in both countries.) This will help to raise Canadian living standards by moving some Canadian jobs out of the low-value-added side of production, which can only generate low wages, and toward the higher-value-added side, which generates higher wages.[11]

These expectations offer a challenge to Canadian governments to provide the education that will equip workers to take the high-value-added jobs that trade liberalization tends to generate. This is true with the liberalization already mandated in the Canada-U.S. agreement, the liberalization that will probably follow from the Uruguay Round of GATT negotiations, and the liberalization that would follow from a tripartite free trade area. Probably *the* most important challenge facing Canadian governments today is to provide the right educational systems to equip Canadian workers with the skills needed to keep the country in the forefront of high-income earners in today's world of fierce international competition in knowledge-intensive goods and services.

If Ricardo's theorizing is not convincing, there is the experience of a half-century of trade liberalization under the GATT in which rich, high-wage countries, including Canada, have done very well by lowering tariffs, not only against each other, but also against the products of poor, low-wage countries. Furthermore, the countries of the EC did not find this a significant worry when they agreed to take in such poorer, low-wage countries as Spain, Portugal, and Greece.

Canadian trade policy since 1947 has been consistent in pushing for trade liberalization as being in the country's best interests. Since it first embarked on its policy of trade liberalization in the late 1930s, Canada has eliminated about 80 percent of its barriers to trade. These massive reductions have occurred in the tariffs levied against all countries, including those that pay low wages. Yet liberalization has been accompanied by steady increases both in Canadian international trade and in Canadian per capita living standards.

Reasons for Opposing the Canada-U.S. Deal that Lead to Support for a Trilateral Deal

It is interesting to note that some of the reasons that led critics to oppose the Canada-U.S. deal should, if applied consistently, argue in favor of pursuing a deal involving Mexico.

First a trilateral deal would lessen Canadian dependence on the United States. Some Canadians worried that bilateral FTA would make Canada too dependent on the United States. A trilateral agreement will reduce this dependence, both by creating Canadian trade with Mexico, and by pointing the way to further plurilateral hemispheric trade liberalization. Such developments will create Canadian trade with each new adherent to the agreement (and thus diminish the relative importance of Canadian trade with the United States).

Second, U.S. dominance over hemispheric trade and investment would be reduced. Some Canadians worried that the Canada-U.S. deal encouraged U.S. dominance in trade and investment. Be that as it may, the evolution of the hub and spoke model of regional trade liberalization certainly would have this effect.

It is a recipe for U.S. domination of the hemisphere through a series of bilateral, divide-and-conquer deals.

In contrast, a trilateral deal would make the emergence of the hub and spoke model less likely by encouraging plurilateral regional trade liberalization. By indicating its support for Canadian participation in the negotiations, *if* Canada wishes to be included, the U.S. administration is indicating that it wants plurilateral regional trade liberalization, not just the U.S.-dominated trade liberalization based on the hub and spoke model. It would be an irony if Canadian opponents to a tripartite deal ensured, against the United States' own desires, U.S. domination of hemispheric trade liberalization by thrusting the hub and spoke model on the participating countries.

Third, a trilateral deal would prevent Canada's isolation from hemispheric trade liberalization. There is also another, much more upsetting, possible consequence of Canada's election to sit out the U.S.-Mexico negotiations. Even if Canada rejects plurilateral regional trade liberalization, that model may be accepted by the other countries who subsequently opt for Latin American trade liberalization. This would leave Canada with its own bilateral agreement with the United States and a growing number of Latin American countries involved in a single plurilateral regional FTA. This outcome would maximize Canada's isolation by maximizing the trade and investment diversion in these markets.

Finally, a trilateral deal would raise the living standards of the poor. Many Canadians worried that the Canada-U.S. agreement would hurt the poor in Canada and the United States. Be that as it may, a trilateral agreement promises to increase the living standards of a nation of 85 million, most of whom are extremely poor by Canadian standards. Even if the tripartite FTA lowered living standards in Canada by 3 percent — which is hard to believe — someone primarily concerned with the *world's* poor should welcome this as a way of alleviating poverty among the Mexican masses.

The trilateral free trade agreement would be vastly more effective in raising Mexican living standards than a 3 percent tax on all Canadian incomes (which would lower Canadian living standards by 3 percent) to raise funds for foreign aid to Mexico. "Trade not aid" has been a call from the less-developed countries for over two decades. Here is a chance to respond to that call with a measure that will certainly raise Mexican living standards and, if historical evidence is any guide, will also do the same for Canadian living standards.

Reasons for Opposing Both the Canada-U.S. Deal and a Trilateral Deal

In spite of the above considerations, it seems a reasonable bet that many who will debate the wisdom of Canada joining in the U.S.-Mexico negotiations will be on the same pro or con side as they were in the Canada-U.S. debate.

For supporters of both initiatives, this will show that they favor trade liberalization in general and do not feel that regional liberalization is enough of a threat to full multilateral liberalization to warrant opposition.

Opponents will fall into two camps, those who oppose trade liberalization in general, and those who support some form of liberalization but not the two cases of regional liberalization represented by the bilateral Canada-U.S. FTA and the trilateral initiative that brings Mexico into the FTA.

General Opposition

The most obvious reason for opposing both the Canada-U.S. and the trilateral deal would be general opposition to trade liberalization — if not at all times, and in all places, at least in Canada's present circumstances.

The case for such opposition was eloquently made some years ago by Abraham Rotstein in his book *Rebuilding from Within*.[12] His views were refuted by the many who supported trade liberalization[13] and they have not been taken seriously by any Canadian government. Since the late 1930s all parties, when

they were in government (although not always when they were in opposition), have supported trade liberalization as a means of enhancing Canadian incomes through expanded international trade.

Qualified Opposition

Other opponents of the trilateral initiative will support trade liberalization under some circumstances while opposing both the bilateral and the trilateral agreements. What are some of the possible reasons for opposing the proposed trilateral deal that are consistent both with *opposing* the earlier bilateral deal and with *accepting* the desirability of some forms of trade liberalization?

Allegation 1 — Regional Trade Liberalization Inhibits Multilateral Liberalization: One view builds on the worry expressed by many commentators that the growth of regional trade liberalization, while advantageous to the participants, will reduce the prospects for genuine multilateral trade liberalization through the GATT.[14] This was a defensible argument for opposing the Canada-U.S. Free Trade Agreement. It could then be argued that by encouraging the growth of regional agreements Canada and the United States were undermining the multilateral process.

This does not in fact seem to have been the case. The rest of the world, including senior GATT officials, accepted the Canada-U.S. arrangement without significant complaints. Furthermore, Canada's participation in the Uruguay Round was not in any way weakened, contrary to what many opponents argued would happen.

In the case of the proposed trilateral free trade agreement, however, the situation is somewhat different. Nothing Canada does is going to prevent the United States and Mexico from doing whatever they decide is in their own interests. Opposition to regionalism is, therefore, not enough to justify opposition to the trilateral initiative. One must further believe that regional trade liberalization is so undermining to full multilateral trade liberalization that, even when others are taking part in it, Canada must ignore its self-interest and stay out of it. The undermining allegation does not seem to be sustained, and, even if it were, the altruism implied by the recommendation to stand aloof would not recommend itself to many.

Allegation 2 — Since the Bilateral Agreement Hurt Canada Economically, the Trilateral One Will Do So as Well: People who currently oppose all trade liberalization for Canada, whether it is organized within the GATT or regionally, will have no trouble advancing the argument listed in the heading. What, however, of those who support multilateralism but oppose regionalism? Most of the allegations that Canada would be hurt economically by the FTA implied that Canada would also be hurt by multilateral tariff reductions. It is hard, therefore, to find, among the numerous arguments that Canada will suffer *economic damage* from the bilateral FTA, ones that are consistent with *supporting* multilateral tariff reductions. For example, if adjustment costs were unacceptably high on removing tariffs against U.S. imports, adjustment costs would be higher on reducing tariffs multilaterally.

Nonetheless, some will advance the argument mentioned in the heading while asserting their support for multilateral liberalization. They will argue that since the Canada-U.S. agreement has been a failure, extending it to Mexico will only compound the failure. (If it is so obvious a failure, one must wonder why the Mexican government is rushing to adopt it.) Opinion polls suggest that much of Canadian public opinion has come to regard the agreement as a failure. The facts, however, show otherwise.[15]

- Many members of the public seem to have accepted the accusations that over 100,000 jobs have been lost and that government has been unable to provide new jobs to replace the lost ones. Since the first tariff cut came into force on January 1, 1989, the

latest figures, from June 1990, show employment in Canada has *risen* by 179,000 jobs. No one said there would be no loss of specific jobs, only that jobs destroyed in some uncompetitive import industries would be replaced by better jobs in competitive export industries.

- There has been a boom in investment both from domestic and foreign sources. It is obvious to most firms, and to the United Nations observers who studied it recently,[16] that the agreement is succeeding in doing more or less what it was intended to do: lead to a restructuring of Canadian industry to be more outward looking and less concentrated in the uncompetitive import sectors.
- The most surprising fact about the Canadian economy in 1989 and 1990 is not the alleged weakness that the FTA was supposed to give to it, but its amazing resilience in the face of an extremely tight monetary policy, leading to high interest rates and a high value of the Canadian dollar. If free trade had given the economy the negative shock alleged by the critics, this, combined with the severe negative shocks of the high interest rates and the high Canadian dollar, would have induced a recession long before now.[17]

The government seems to have taken the defensible position that it is not worth entering this debate in any serious way. Its position seems to rest on two beliefs. First, the benefits of the FTA will become obvious as time passes. Second, no matter what party members may say in public, no future Canadian government would contemplate rescinding the FTA. Therefore, so the argument goes, there is no point in getting into a messy debate on the benefits of the FTA at this time.

This position was defensible as long as another decision on free trade was not needed. Now, however, a decision on whether or not to enter trilateral negotiations is needed, and the incorrect belief of the public that the present FTA is a failure will assist those making the anti case.

There may be another, less creditable, reason why the government is keeping out of the present debate on the benefits of the bilateral FTA: it has been inclined to minimize adjustment problems. For example, it assured the food-processing industry that there was little cause for concern. More neutral supporters argued that the government had to choose between the supply-management schemes in agriculture and a healthy food-producing industry. The government chose to support supply management and the food-producing industry has suffered some severe consequences. This ducking of the issues of inevitable, and necessary, adjustment may make it more difficult to defend a tripartite arrangement, which would, without doubt, entail some significant adjustment costs.

Conclusion

Trade liberalization has served our nation well since we embarked on that path earlier in this century. It continues to do so. To one of the world's most open economies, for whom trade is part of lifeblood, plurilateral trade liberalization could hardly be anything but a boon — in spite of some significant adjustment costs, which are the vehicle by which the gains from further trade are realized.

Canada now has a chance to take part in a historic movement toward hemispheric trade liberalization. It is in our self-interest, and in the interest of the vast number of less-well-off people in the rest of the Americas (as well as the higher-income people) for this movement to be successful.

Let us hope that we do not desert our self-interest, and our obligation to help others, because we Canadians are afraid. Confidence in our country and in our ability to compete in the tough game of international trade is what is required. Canadians can do it. All we need is the courage to enter the new hemispheric game in the first place.

Notes

1 I am indebted to Murray Smith for helpful discussions of the content of this paper. Since writing this paper, I reviewed a manuscript by Michael Hart which looks in more detail at many of the issues that I raise here. Hart goes through the Canada-U.S. agreement chapter by chapter and identifies those items which may cause difficulties in trilateral negotiations. See Michael Hart, *A North American Free Trade Agreement: The Strategic Implications for Canada* (Ottawa: The Institute for Research on Public Policy and The Centre for Trade Policy, forthcoming, November 1990).

2 Under the fast-track procedure, Congress cannot amend the agreement that is negotiated between the two negotiating teams — although interested parties, including key congresspersons, are consulted throughout the negotiations. When it is finally presented, Congress must either accept the deal as it is or turn it down in its entirety.

3 One major problem casting a shadow over Mexico's outlook is the foreign debt accumulated in the 1970s. Opinion differs among Mexican officials as to how much of a burden this debt will continue to impose on the country. The debt has been a major depressing factor on Mexican living standards in the 1980s. Developments in the Middle East that returned oil prices to US$25 or more could work wonders, provided that the oil dividend was primarily used to reduce the debt.

4 I follow usual practice in reserving multilateral to refer to very broad groups of nations and plurilateral to refer to smaller groups. There is no definitive dividing line between the two, since the GATT does not include all nations, and plurilateral groups could be as small as three countries and as large as all those of the western hemisphere.

5 Trade negotiators might prefer to bargain bilaterally, which is easier than attempting to reach trilateral agreements and compromises. Others might worry that Canada would come to the table and then act as a spoiler, taking as their model Mrs. Thatcher's current behavior in the EC. But the consequences for Canada-U.S. relations would be so serious that no responsible Canadian government would take that course.

6 Murray Smith and I have briefly discussed the issues dealt with in this section in "The Canadian-U.S. Free Trade Agreement: Special Case or Wave of The Future?" Chapter 14 in *Free Trade Areas and U.S. Trade Policy*, edited by J.J. Schott (Washington: Institute for International Affairs, 1989).

7 My reasons for not objecting to the energy chapter, including the agreement on sharing in times of energy crisis, are laid out in Lipsey and York, *Evaluating the Free Trade Deal* (Toronto: C.D. Howe Institute, 1988).

8 Murray Smith and I made this suggestion in Schott, ed., *Free Trade Areas*.

9 It is worth noting that the opening of trilateral negotiations would probably put the bilateral negotiations of a subsidy code — now in suspension until the Uruguay Round of GATT negotiations is completed — off yet again. It seems unlikely that the general trilateral negotiations and the specific bilateral subsidy code negotiations could fruitfully go on at the same time.

10 An exact equality between imports and exports (zero balance) only occurs if capital flows are zero. In today's world, large net flows of capital occur. Ricardo's analysis then shows that the imbalances between exports and imports produced by the exchange-rate mechanism will be those needed to finance capital flows — trade deficits in capital-importing countries and trade surpluses in capital-exporting countries.

11 Detailed studies, under way but not completed, are required to predict which particular lines of production will expand and which will decline in each country. In the meantime, the knowledge that Canada has gained from all previous rounds of trade liberalization, plus understanding the enormous potential for hemispheric trade liberalization, provide sufficient grounds for supporting the trilateral initiative. Just as the Canadian government did not need detailed impact studies before each round of negotiated GATT tariff reductions, such studies are not needed now as a basis for support of the proposed initiative. Such studies will, however, be valuable for many other reasons, including the provision of advanced knowledge of where the adjustment problems will be most serious.

12 A. Rotstein, *Rebuilding from Within: Remedies for Canada's Ailing Economy* (Ottawa: Canadian Institute for Economic Policy, 1984).

13 See, for example, R.G. Lipsey and M. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World* (Toronto: C.D. Howe Institute, 1985), pp. 57–62.

14 My own reasons for rejecting this argument are given in Lipsey and Smith, in Schott, ed., *Free Trade Areas*.

15 The absence of a documented refutation of the incorrect perception that the FTA is causing economic harm makes it easier for the opposition to allege that the tripartite agreement will harm Canada economically.

16 See *UNCTC Current Studies 15* "Regional Economic Integration and Transnational Corporations in the 1990s" (New York: United Nations, 1990), pp. 31–34.

17 Now that a recession finally seems to be on the way in mid-1990, the fall in employment that may ensue will no doubt be blamed on the FTA. It will be obvious to any neutral observer, however, that the recession is a cyclical phenomenon related to world demand conditions and locally tight monetary policy rather than to reductions in tariffs that have probably averaged less than three percentage points so far. If the FTA were to blame, the unemployment would be concentrated in import-competing industries rather than being economy wide, as it would be if declining world demand and the tight monetary policy were to blame.

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